THE MEASURE OF INCOME FOR TAXATION

That the far more general acceptance of the income tax in the United States is practically assured few, if any, persons now seem inclined to doubt. There can be very little question that the constitutional amendment submitted to state legislatures by vote of Congress will within a reasonable time secure enough favorable ballots to insure its adoption. As Professor Seligman in his recent comprehensive work on income taxation has expressed it:

> Sooner or later the constitutional or political difficulties will be surmounted, and the United States will fall in line with every other important country of the world. Economic conditions have everywhere engendered a shifting of the basis of taxable faculty, and democracy has declared that the best criterion, on the whole, is to be found in income. Whether we like it or not, the development is irresistible, and the income tax will come to stay until some new criterion of ability approves itself to the democracy of the future.[1]

When this result shall have been reached, there will be no further question regarding the general power of Congress to impose an income tax, but the interpretation of principles and the adjustment of details will have to be dealt with by the courts. If it is granted that the adoption of the income tax as a general source of federal taxation can hardly be avoided, whatever may be thought of it by advocates or by opponents, the means of imposing the tax, the basis for fixing its rates, the terms and conditions of every kind upon which it shall be employed will then assume the place of predominant importance which is now assigned to the constitutional question. With the general verdict of Professor Seligman not many will differ. It is the verdict not only of the academic student of taxation but of the practical man and the observing legislator and administrator as well. How to adjust the income tax when adopted in such

[1] Seligman, *The Income Tax*, p. 672.

a way as to realize: (1) accuracy and honesty of returns; and (2) adequacy of product, will continue to be the central problem for those whose duty it is to devise fiscal systems. If, while attaining these objects, they can at the same time succeed in creating a public sentiment which recognizes the justice of the methods in the application of the tax, the main obstacles which stand in the way of the introduction of this resource will have been overcome.

I

Determination of the proper measure of income has always been one of the principal difficulties with which those who have advocated the income tax in theory and practice have had to contend. A faulty criterion or basis by which to measure incomes has led to inaccuracy in returns and dishonesty on the part of the contributor, who has been disposed to justify evasion of the tax on the ground of its manifest inequity. Even where conditions of collection have been such as to render evasion impossible or nearly so, administrators and theorists have recognized the importance of some satisfactory measure of income which would meet the demands not merely of abstract justice but of the economic conditions surrounding and determining the development of saving. An accurate measure of income for use in fixing the basis of taxation has, therefore, been recognized as absolutely fundamental to success. In this connection, three important questions present themselves—those of exemption, of differentiation, and of progression. The view of income taxation which is probably most widely accepted today regards the exemption of a so-called "subsistence minimum" as a necessity in any income-tax law. In the same way the more radical advocates of the income tax, who are doubtless growing in number, are friendly to the notion of progression. Most of them believe that the rate of income taxation should be fixed at comparatively low figures for incomes above a moderate exemption minimum, and should increase slowly until the higher incomes are reached, when the rate of advance should be more rapid. The view that the rates should become so highly pro-

gressive as practically to absorb all incomes above those upon a definite high level has reached some degree of popularity, but the plan has not spread sufficiently widely to be considered a practical proposition. It may therefore be assumed that the conception of income taxation which has won its way to the front is that of moderate progression within fixed limits and with the exemption of a high subsistence minimum.

Just why a subsistence minimum should be exempted at all, and why such minimum if exempted should be a large one, could not be briefly stated. The idea has been a slow growth. But generally speaking it rests not only upon the view that for the lowest grade of income the difficulty of collection, the high cost involved, and the offensive inquisitorial features are so obnoxious to the payer as to render it impossible to gather in a surplus of revenue, but also on the view that even if such a tax upon the lower incomes could be collected, its payment would result in a more than corresponding decrease of economic power. The workman, with an income of $500 or $600 per annum, from whom a tax of, say, 2 per cent, amounting to $10 or $12, might be collected would, in parting with this sum, be deprived of an essential part of his income—a sum whose expenditure is literally necessary in order to maintain him as an efficient economic worker. That being the case, the state, in taking a part of the smaller income by taxation, practically impairs the basis for taxation—such is the theory of the more enlightened writers who urge the exemption of the subsistence minimum.[2]

If this argument be analyzed it will be found to be equivalent to the view that, in the smaller incomes whose exemption can be defended, there is no appreciable or definite margin for saving. While in some cases, owing to exceptional frugality or to relief from family cares, the recipient of the income may have a margin for saving and may actually save, such is presumably not the case with the bulk of the contributors in the class. Reduced to its lowest terms, therefore, the argument for exempting

[2] The general doctrine of the minimum of subsistence is very well discussed by Palgrave, *Dictionary of Political Economy*, II, 769. Seligman considers its application to the theory of taxation (*The Income Tax*, pp. 27–29). Cohn, *Science of Finance*, pp. 327 ff., develops the argument against it.

a subsistence minimum from taxation is practically an argument for imposing taxation only upon those incomes in which there is a possible margin for reasonable or legitimate saving; and this would imply that the incomes properly to be taxed should be those only from which, after making full provision for the efficiency of the recipient from every standpoint, there would remain a surplus of net wealth that might be disposed of at will and whose use by the state would be more profitable to the community than its use by the individual.

By some reasoners on taxation, this apparently has been considered equivalent to a view that income taxation should properly be based upon savings. The expressions of numerous writers on finance appear to support this view when hastily examined. Professor Seligman for example defines income as "that which comes in to an individual above all necessary expenses of acquisition and which is available for his own consumption."[3] He then shows that the real source of taxation is the net income or net revenue received by an individual during a given space of time. Adams[4] takes the same point of view, and Bastable also practically adopts it.[5] But, looked at more carefully, this acceptance of net economic income as the proper source and measure of taxation does not necessarily lead to the doctrine that income taxation should fall upon, or be commensurate with, savings. On the contrary, it is here contended that the reverse is the case. Professor Seligman, the most recent, as well as probably the most thorough of the systematic writers upon income taxation, by clear implication rejects this view. After showing that "net" income is the proper basis for taxation, "meaning by net income gross income minus expenses incurred in acquiring it," he goes on to inquire whether it is permissible that the conception of "clear" income shall be substituted for that of "net" income. His conclusion is adverse; "for," says he, "it would practically mean that a man should be permitted to deduct from his net income all the expenses which he might deem necessary." Professor Seligman further notes—what is for the purposes of this

[3] *The Income Tax*, p. 19.

[4] *Science of Finance*, p. 332.

[5] *Public Finance*, pp. 470 ff.

study very important—that "to a certain extent . . . . allowance is actually made for this point of view by all modern governments, in that abatements are granted for children or other dependents and so far as further allowances are accorded for exceptional expenditures." Working further along this line of thought it is seen that the significance of it is that, whereas net income is the ultimate source of taxation, the essential measure of income for tax purposes must be the economic character of such income —the use that is likely to be made of it as contrasted with the use certain to be made of it by the state. Thus, although it is true that savings are the source of income taxation, in that the taxation diminishes, or is paid from, such savings, it is not true that financial theory dictates the imposition of taxation in proportion to savings, or that it would limit the amount of taxation to be collected, by average savings made or potentially to be made in a given group of income recipients.

There is another aspect in which this same point of view may be considered. Economists distinguish sharply between kinds of income and they urge that income taxation shall be more and more adjusted, not merely by reference to gross amounts but by reference to the fundamental economic character of the wealth received.[6] By this is meant that of several individuals who enjoy equal incomes of say $10,000 a year each, one may receive his income as the result of investments, while a second may earn it through professional work; and a third may earn an equal amount by business operations. In these instances, the source of income in every case is different and the effect of taxation applied equally to these equal amounts is different in each case, because of the varying reflex effect it exerts upon the activities of the contributor. It has been a difficult matter to suggest means for adjusting taxation to income in accordance with the economic nature of the funds received, and this leads to the question whether such an adjustment may not be arrived at by a method the converse of that which would ordinarily be adopted. For instance, if it were granted that above a certain

[6] Cf. for example Plehn, *Introduction to Public Finance*, p. 234, where the view is indicated that earnings should not be exempt from taxation.

specified sum income should be taxed at a higher rate, if received from accumulated property than if received from professional earnings, the question would be how to differentiate in practice between incomes received from these two sources. There would be great difficulty in obtaining truthful reports as to the proportions of a given income made up from returns on capital invested and professional earnings. Yet somewhat the same result, so difficult to get in this instance by means of the direct return, can be reached through a study of the uses of income. While by no means a universal rule, of course, it will be found that the bulk of large incomes are the result either of return upon invested capital or of business profits. Only in a small degree do the larger incomes consist of salaries or earnings. It may fairly be assumed that in the vast majority of cases, therefore, expenditures beyond a moderate sum are likely to be drawn from incomes derived either from interest on invested capital or from business profits. In a few cases large personal expenditures will be made from exceptionally large earnings and in a few others they will be met by actual outlays of already saved capital. But in a majority of cases neither of these latter contingencies will be true. This suggests that a plan which would measure income for taxation on the basis of the amount spent rather than on that of the amount received would tend toward the classification of incomes. That would permit the varying of rates in such a way as to fall more or less heavily—as might be desired—upon the great mass of incomes whose larger proportion was undoubtedly derived from returns to capital, or more or less heavily upon that grade of income probably the result of personal work or service, or of this latter combined with a small element of interest on capital. While the problem of determining upon a rate of taxation best suited both to the different amounts and sources of taxation is and will continue difficult there is much reason to believe that a classification of incomes for taxation in proportion to the expenditure of the recipient would come as close as any method to the segregation of earnings, inasmuch as those whose incomes fall within the highest class are in largest measure the recipients of interest and

business profits, while exempted minimums will be primarily wages, and the lower classes of income above such minimum rate will consist of earnings or of earnings supplemented by interest or profit.

By the side of the problem of segregation and classification of income there has been developed that of the rate at which incomes should be taxed. On this subject, the drift has doubtless been toward the adoption of a lower rate for the lower incomes with a constantly increasing rate for those of larger amounts—a system known as progressive taxation. The argument in behalf of progressive taxation is tolerably familiar. It is assumed that the recipient of the larger income is able to part with a proportionately greater sum than the recipient of the smaller income. Assuming that a dollar represents the same sacrifice to one individual that it does to another, it is asserted that the man who has provided for the elementary necessities of life can better afford to spare a part of his surplus income than he who has not been ablē to make such provision. For these reasons, it is demanded that the man who has $10,000 of income shall be taxed more than double the rate imposed upon him who has $5,000 while the logical consequence of this attitude is the demand for an increasingly great burden to be imposed as incomes advance to higher and higher figures.[7] The theory of progressive taxation has been subjected to severe criticism. It has been effectively pointed out that the sacrifice of a dollar does not entail the same suffering upon two men of equal income nor is the sacrifice necessarily less as income increases. For these reasons, the theory of progressive taxation is inadequate, if the object sought be that of equalizing sacrifice.[8] On the other hand, very grave difficulty has been found in the fact that a convinced and thorough application of the doctrine of progressive taxation would necessarily check accumulation and would thereby tend to force out of the productive class in the community those elements which were best capable of the development and accumulation of wealth. But, while the doctrine of progressive taxation has usually been found

[7] The best account of the theoretical basis of progressive taxation is given in Seligman's monograph *Progressive Taxation.*

[8] Cf., e.g., Adams, *Science of Finance*, pp. 347–48.

in conjunction with the view that a minimum of subsistence should be exempted, attention has seldom been given to the circumstance that the theory which would warrant the exemption of a minimum of subsistence could be held to warrant the application of progressive rates of income taxation. If it be true that the real reason for exempting the minimum of subsistence from taxation is the fact that a greater social utility is realized and a greater advance in economic strength is thus made than by taking the wealth for the use of the state, it would appear that the same criterion should be applied to the higher incomes. If it were so applied, would not a determination how to tax the larger incomes of the community necessarily depend, as in the case of the lower incomes, upon the way in which these incomes were used? Would there be any warrant for increasing the rate of taxation upon the large income merely because of its size? Would not the rate of taxation be logically fixed by principles depending on the disposition of the income in the generality of cases? What could such principles be? They could be those only which would discriminate between unwise uses of income and uses which were considered obviously for the benefit of society. If there were a uniform standard of human wants, and if it were possible to draw a sharp line of division between those of a legitimate or useful character and those of an undesirable or uneconomic character, the principles which lead to the exemption of the minimum of subsistence would likewise lead to a recognition of the differences between the uses of income in the higher grades. In the case of the man with the small income the obviously correct assumption is that the vastly greater proportion, if not the whole of the income, will be devoted to those uses which tend to strengthen the individual and make him a better producer and member of society. If it were not so, there would be no argument for exempting the minimum of subsistence, and since this is true in the majority of cases, it is fair to overlook the small percentage of instances in which the resources of the man of small means are squandered instead of being used for legitimate purposes. With the larger incomes in which an unlimited field is opened for the choice of objects

of expenditure, the selection of a canon of taxation becomes harder, although there is no reason for a change in the objects to be aimed at in making a choice. Since it is not true that any uniform standard of human wants exists, since it is not true that expenditures may be classified with even approximate accuracy as desirable or undesirable, it is feasible only to apply taxation in accordance with some general guiding principle. The most general and easily selected principle of this kind that suggests itself is necessarily one based upon a distinction between reasonable and excessive expenditure. Such a principle would dictate that in taxing the larger incomes, higher rates should be imposed not in proportion to size of income but in proportion to size of unnecessary or uneconomic expenditure. The chain of development from the lowest income to the highest would then be complete. We should have at the base of our scale of incomes a certain number whose owners were exempted from taxation upon the ground that on the whole they were more likely to employ their funds in such a way as to advance social well-being than the state would be were it to take through its sovereign power a given percentage of such incomes. Secondly, we should note above the exempted class, a group of income recipients whose taxation would be graded at a moderate rate, so long as their expenditure did not exceed a specified amount; and thirdly, a class of income recipients whose taxation would be placed upon materially higher basis because of a habitual expenditure in excess of the amount included within the so-called reasonable limits. If the minimum of exemption were set at, say, $5,000, while an additional $10,000 was regarded as a sum which could properly be expended without subjecting its owner to additional burdens, the three classes would consist, first, of those with incomes up to $5,000 free of taxation, those with incomes in excess of $5,000 but whose expenditure was not in excess of $15,000, paying a specified rate of moderate amount upon everything above $5,000 and under $15,000, and those with incomes in excess of $5,000 but whose expenditure was in excess of $15,000. The latter class would pay the specified moderate rate upon the $10,000 of their income intervening be-

tween the \$5,000 and \$10,000 level, and the higher rate, whatever it might be, upon the sum received as income in excess of \$15,000 but expended by the recipients. Under this plan, what would become of the income received by those persons whose annual returns were in excess of \$15,000 but whose expenditures did not exceed that sum? It might be subjected to a level rate of taxation or might be free of taxation so long as its recipient refrained from consuming it, and instead saved and reinvested it.

II

What would be the effect of such a system as that which is thus described? Its manifest object would be to place a premium upon moderate expenditures and to tend to restrict expenditures in excess of the sum designated as moderate or reasonable, in so far as taxation produced that result. Several important questions both of administration and of economic and financial theory are raised by this proposal. The latter may be considered first. It is clear that the tendency of such a regulation would be to promote saving and to limit expenditures. Assuming that the effect thus indicated was actually produced, the result of the tax would be a more rapid advance in the accumulation and investment of wealth. This would be precisely the opposite of the influence of progressive taxation. Under the progressive system, the condition to be penalized is the possession of a large income, no matter from what source that income may be derived. Under the system here suggested, the condition penalized is the expenditure of a large proportion of a large income. Progressive taxation naturally tends toward the limitation of income or toward the non-acquirement of income beyond a certain point. Income taxation which bears more heavily upon expenditure than upon saved incomes puts a premium upon reinvestment. It leaves the recipient of income in the full possession of every inducement to enlarge his earning power except that which comes from the desire for immediate expenditure. Even the latter is retained in a measure, since there is nothing to prevent later expenditure if the owner of income desires to adopt a more lavish scale of outlay in the future.

From the broader economic standpoint, the effect of such a policy of income taxation would be the same as that of any policy which aimed at the increasing of productive capital or wealth. These effects are well known. The saving, which might follow in greater measure from the use of taxation to promote it, would have the same effect as other saving—an effect which has been analyzed by Mill in the following language:

> What supports and employs productive labor, is the capital expended in setting it to work, and not the demand of purchasers for the produce of the labor when completed. Demand for commodities is not demand for labor. The demand for commodities determines in what particular branch of production the labor and capital should be employed; it determines the direction of the labor; but not the more or less of the labor itself, or of the maintenance or payment of the labor. These depend on the amount of the capital or other funds directly devoted to the sustenance and remuneration of labor.[9]

And again:

> Saving . . . . enriches . . . . the community along with the individual; which is but saying in other words, that society at large is richer by what it expends in maintaining and aiding productive labor, but poorer by what it consumes in its enjoyments.[10]

The inference from this view of the economic basis of our suggestion is important not only from the standpoint of the general wealth and well-being of the community but also from that of financial theory. The growth of saving—that is of reinvestment and capital with correspondingly great demand for labor—necessarily means the greater development of that class of income which will be subject to taxation under the terms of any legislation on the subject. If a greater demand for labor is brought about through the increasing investment of capital, this means a necessary tendency toward higher wages. The income which might have been consumed by the larger owner or recipient is diffused among a much broader class of small-income recipients and tends to place them in a stronger economic position, ultimately adding them to the class whose incomes may become

[9] Mill, *Principles of Political Economy*, Book I, chap. v, sec. 9.

[10] *Ibid.*, sec. 6.

subjects of moderate taxation. Moreover, the return obtained by the original investor of surplus income which might otherwise have been immediately expended is enhanced through his fresh investments, and if the effect of the system of taxation continues to operate upon his mind as at first, the consequence is to add to the total of receipts which are subject to the higher rate of return to the state. Contrasting this with the effect of progressive taxation, it is to be observed that from the economic standpoint the consequences to the community will be superior to those produced by the progressive system: (1) as regards the capital investment and consequently the possible employment of the community; and (2) as regards the basis of taxation afforded to the state.

In one important particular, however, there will be a material difference between the two systems. This particular is the concentration of wealth. One of the chief arguments in favor of progressive taxation that is advanced by those who urge it, particularly by its more radical or extreme supporters, is the fact that when successfully applied with a highly progressive rate, the system restricts the development of large incomes and tends to limit the accumulation of property in few hands.[11] This, it is conceded, is secured by the more or less forced retirement of the abler minds from active business after they have reached a point at which their income is largely absorbed through progressive taxation, but it is alleged that the good thus accomplished in limiting the accumulation of wealth far more than offsets the evil effects of the limitation upon business activity which is incidental to and inseparable from the plan. This is undoubtedly one of the most, if not the most, debatable aspects of progressive taxation. The sumptuary phase, or, as some like to term it, "socialistic" aspect, of the tax in limiting the development of great private wealth is by supporters presented as the greatest merit of progressive taxation, and by opponents as its greatest demerit. A settlement of this controversy for purposes of this study could be had only by the full threshing out of the widely divergent views of two important schools of economic thought—

[11] Adams, *Public Finance*, p. 341.

a task which will not be even attempted in this discussion. Two points, however, should be raised in this connection.

First, if it shall be held that the limitation of great incomes and of large accumulations of individual property is desirable, the object is far better obtained by rigid inheritance-tax legislation than it is by income taxation.[12] It is the universal verdict of economists and students of finance that, whereas income taxation is notably difficult in application and particularly subject to evasion, inheritance taxation, owing to the legal requirements surrounding the transfer of property, is equally certain and at the same time inexpensive in its collection. The principal obstacle to inheritance taxation at a rate high enough to afford an effective check upon great fortunes has been the transfer of property prior to death. But even this has not sufficed to interfere very greatly with the successful operation of inheritance taxes. With our system of property holding, the accumulations of a single lifetime are fully within control, and under a system of suitable income taxation which checked rather than promoted useless expenditure the employment of progressive inheritance taxation could be made adequately to meet its object.

Second, the question should be considered whether it is not of greater importance to check unreasonable and unnecessary expenditures than it is to check the mere centralization of ownership in the way that would supposedly be afforded by progressive income taxation. It is at least a fair field for controversy whether much more harm is not done through wasteful and luxurious expenditures than through centralization of wealth-ownership or through growth in wealth-ownership consequent upon the continuous reinvestment of savings.

Thus the adoption of an income tax based upon expenditure rather than upon the size of incomes alone, and perhaps progressive in proportion to expenditure rather than progressive in proportion to gross income, could be made, by the aid of the inheritance tax, to meet all of the requirements set before themselves by the radical and reformatory advocates of progressive

[12] Cf. Seligman, *Essays in Taxation*, pp. 122 ff.

taxation in the usual form, while it would further operate to check extravagance and would thereby enlarge the basis of taxation as well as the opportunity for wage-earning furnished to the community.

III

It is now necessary to inquire how the adoption of an income tax based upon expenditure in the way already indicated would affect the income-producing power of the tax itself and consequently the revenues received by the state as a result of it. One difficulty with the ordinary form of progressive taxation has always been seen in the fact that as the rate rose the yield declined. The amount that could be collected from the higher incomes beyond the point where the rate of taxation became very heavy was small. This was partly due to the operation of the tax itself in removing the incentive to the development of the higher incomes, but was also in part due to the growth of methods of evasion. The general agreement among authorities on taxation is that, under ordinary circumstances, the use of a tax for exclusively police purposes or purposes of control is not wise. While exceptions may be noted, the test of a good tax is found in its productiveness, and productive taxes are usually more effective in bringing about general or important economic changes than are those whose yield is small or negligible. All this makes it important to know how the use of such a measure of income for taxation as is here recommended would affect the power of the tax to yield revenue. It may be admitted that if the plan proposed would result in considerable curtailment of net revenue its chances of successful acceptance would be greatly diminished; for, as was noted at the beginning of this discussion, the undoubted tendency today is toward an increasing use of the income tax as a fundamental source of revenue for the state. A broad conclusion concerning the way in which this form of the tax would operate may be arrived at by analysis. As we have seen, so far as the exemption of the minimum of subsistence covering the lowest class of incomes is concerned, the proposed plan would not differ from any other. Its effects would be the

same because in both cases the minimum incomes (wherever the line of exemption might be drawn) would be relieved of payment. Above that line (in what we have called on page 663, *supra,* the second class of incomes) the yield would depend entirely upon the rates applied. Supposing that the second class of incomes, including those which were designated as representing a "moderate" expenditure, were taxed at the same rate as the ordinary or normal rate of taxation imposed by the income tax in its usual form upon all incomes, up to the point where the first step in progression occurred, there would be no reason to anticipate any difference in yield between the two modes of imposition. In the last analysis then the choice of a method of income taxation from the standpoint of revenue yield, would have to be based upon the probabilities of state revenue derived from income taxed at a progressive rate or perhaps taxed only at a proportional rate applicable to all sums above a given amount on the one hand and on the other the return obtained by the taxation of those incomes which were actually expended in excess of the given sum or level selected as the dividing line. It is clear that no positive conclusion on this point can be arrived at partly because there has been no experience of an exact kind which would permit comparisons, and partly because no accurate prediction could be made as to the working of the proposed tax without a decision as to the extent of the burden to be laid upon the taxed portions of income. Only general reasoning, then, can be applied to this phase of the subject. In making such a general analysis of the case, however, a few points may, it would seem, be taken as tolerably certain. It is noteworthy that the yield of progressive taxes in those instances where the rate of progression is at all considerable is disproportionately small and has tended to become rapidly smaller with the increase in progressiveness.[13] Where proportional taxation has been applied irrespective of the size of the income and without any attempt at progression the returns have been much better. But even with proportional taxation, experience has shown that the difficulty of securing a true report of large incomes is much greater than that of secur-

[13] Leroy-Beaulieu, *Traité de la science des finances*, I, 152 ff.

ing an equally trustworthy return for moderate incomes. Both at the upper and at the lower ends of the scale of incomes, therefore, does it appear that the difficulty of collection becomes disproportionately great as compared with the return. It is the medium incomes which are the most productive field of taxation and which occasion the least difficulty in collection. The plan which is here suggested therefore would conserve this intermediate field; while in comparing the yield likely to be had through the taxation of large incomes which were expended above the dividing line drawn by law with that likely to be had through other methods, it should be borne in mind that this higher field is one where the difficulty of collection is in any case considerable and is therefore a fair field for experimentation. But more important than this is the fact that under the proposed plan the detection of erroneous returns would be far simpler than under the alternative methods which are in vogue at present. Expenditure is invariably easier to detect than is saving and it involves far less inquisition into matters which are properly regarded as private business. Certain obvious and efficient criteria of expenditure are easily available. On all of these grounds, therefore, it is fair to expect that in so far as the income tax here suggested was actually levied upon the higher incomes, owing to the fact that such incomes were expended instead of being saved, it would be more productive than its competitors. Whether, if levied at a sufficiently high rate, it would be successful in greatly reducing expenditure and in as greatly advancing reinvestment, may be questioned; but in so far as it accomplished this latter object the loss of revenue thereby occasioned would, it is believed, be more than offset by increase of social advantage.

IV

If it be objected that the idea of exempting saved income from taxation is an innovation in theory the answer may properly be made that it is an innovation only in extent and scope. The idea of exemption as thus far discussed in this paper has been applied solely to the minimum of subsistence which, it has been

argued, should be relieved of all burdens for reasons already sufficiently set forth. But the idea of tax exemption has been given a much wider scope than this in actual practice. Not only have our states exempted from taxation many specified classes of property such as municipal bonds, but the same notion has been widely applied in other directions.[14] Possibly the most interesting application of this notion of exemption in the direction which is here suggested is seen in the system, pursued in not a few places, of exempting insurance premiums. This is well illustrated in the English income-tax system. Up to one-sixth of the income the English system permits the exemption of insurance premiums, although this concession is not granted to savings in general. Here the effort is to encourage thrift in a particular form, and by relieving the saver of the burden of taxation to induce him to put his saved wealth into a certain kind of protection for his family. The idea has operated successfully so far as it has been applied, but the extent of the application has been limited. The argument, however, which would dictate the exemption of savings in the forms of insurance premiums would also apply to many other classes of savings which from certain standpoints are as worthy of encouragement as life-insurance premiums. It may further be inferred that the extension of the exemption of all savings beyond a certain point is also recognized as theoretically desirable whenever the exemption of any savings is recognized. The adoption of the exemption policy admits the efficacy of the remedy suggested although its application is limited in the English system by fear of interference with revenue and other considerations. Other interesting examples of the principle of exemption may be found under foreign income-tax systems. In the Austrian system, for example, not only the minimum of subsistence is free of taxation but there is a special exemption for each dependent person in a family beyond two, while allowances are made for any circumstances which diminish the ability to pay, such as illness, assist-

[14] For a review of state systems of taxation see *Taxation and Revenue Systems*, published by the U.S. Census. Foreign practice in this matter is reviewed by Seligman in *The Income Tax*, already referred to. See also *Report on Valuation, Taxation, and Exemption in Pennsylvania*, 1892, *passim*.

ance of parents, education of children, or military duty. In all these the idea has been distinctly that of relieving from taxation those outlays which, freed of restraint, contribute to the greater good of society.

In the United States, moreover, the notion of exemption from taxation has been recognized by our courts as fully resident within the legislative branch of the government. It has been a broad and permanent principle that taxation shall be equal and uniform throughout the United States and that in no respect shall those be freed of taxation to whom it is desired to accord merely a legislative favor. Nevertheless, it is fully recognized that, providing an exemption be general, so as to apply to all persons similarly circumstanced in precisely the same way, it must be upheld. The courts have held that while special classes of property may not be exempted from taxation all property may be when circumstanced in a specified way. Thus in the case of *California* v. *McCreery*,[15] it was held that no power exists in the legislature to exempt specified classes of property inasmuch as "the exemption may be carried still further until property of one class is made to bear the whole burden of taxation." But this does not prevent the classification of property. As was said by the Federal Supreme Court in the case of *Magoun* v. *Illinois Trust and Savings Bank*,[16] "The state may distinguish, select and classify objects of legislation, and necessarily this power must have a wide range of discretion." Speaking specifically of exemption the court in this same case said: "It is true that the amount of the exemption is greater in the Illinois law than in any other, but the right to exempt cannot depend on that. Whether it shall be $20,000 as in Illinois law, or $10,000 as in that of Massachusetts, or other amounts as in other laws, must depend upon the judgment of the legislature of each state, and cannot be subject to judicial review." And again, "The rule [of uniformity under the Fourteenth Amendment] does not require . . . . exact equality of taxation. It only requires that the law imposing it shall operate on all alike under the same circumstances." The idea of progression in income taxation

[15] 34 *California Reports*, p. 432.

[16] 170 *U.S. Reports*, p. 283.

has been upheld by the courts in that special phase of income taxation which applies to inheritances, and this has been reiterated in more than one well-reasoned opinion.[17] Our legislative bodies—the power of Congress in this regard being precisely parallel and similar to that of the states—can classify and arrange incomes for taxation as they please, and can exempt portions of income as they choose, provided that such incomes are classified and exempted according to principles which discriminate in favor of no individual or class of individuals and which place all upon the same basis in so far as they conform to the same requirements and act alike under similar circumstances. It is an undoubted fact then that in American public law the plan of exemption which is here suggested would meet with ample support and that it could not be antagonized upon the ground of unconstitutionality or of its being repugnant to the spirit of the Constitution.

V

There remains the question whether social and economic conditions in the United States are of such a nature as to call for the use of the power of the state in restraining expenditure. On this score, the developments of the past few years appear to afford a decisive verdict. Census estimates of public wealth show an enormous increase from decade to decade. How great an increase in actual income has taken place, available statistics probably would not indicate in any accurate manner. Still less is it possible to make positive statements concerning the distribution of incomes or the extent to which surplus incomes are employed in given ways. But a minute statistical study is not necessary to furnish convincing proof of the tremendous and probably disproportionate development of luxurious expenditure in the United States. The rapid expansion of all branches of manufacturing which supply commodities of the more costly class and especially of those which furnish objects of luxury, of taste, and art, is a familiar and obvious fact. Coupled with this is the rapid development of standards of extravagant outlay

[17] Cf. *Knowlton* v. *Moore*, 178 *U.S. Reports*, p. 41.

heretofore unknown. The effect of these standards in greatly diminishing the saving capacity of persons of moderate means has long been a subject of anxiety. Its reflex effect in tending to raise prices and therewith to render the problem of existence even harder for the average man has also come sharply under the notice of investigators of every grade. It has been mentioned by the Senate committee which investigated the cost of living in 1910 as one of the factors tending to promote the increase of prices.[18] That this judgment is correct few probably will be disposed to question. The economic effects of an over-extended standard of living might be enlarged upon, but are sufficiently familiar to students of economics. From the social standpoint the objections to the present tendencies in the expenditure of wealth are even more marked than from the standpoint of economic theory.

The scale of living in America is now too high. It is not true, as so many think, that this affects the rich only. Lecky in England and Taine in France have observed that the scale of luxury of the very rich sets the pace for the other classes of society. The influence of the rich man's example must be all the greater in the United States where the sentiment of equality is so much stronger, and where no traditions of sumptuary laws separate class from class. A little education in sociology would soon teach our spendthrift multi-millionaires that the great man's palace and castle which once had a real use as an appanage of feudalism are now mere useless survivals. Rich Americans should remember the answer made to the King by the Prince de Rohan when reproved for his own extravagance and that of his subordinates: "Sire, if they are extravagant, it is their own fault; if I am, it is the fault of my ancestors."

Sermons on the simple life, from Socrates to Charles Wagner, have had little effect in lessening man's extravagance. It will only be when the effect of extravagance, by lessening the aggregate wealth and by its diversion of labor from useful to useless channels, is generally understood more keenly, that an effective public opinion can be formed against it. A campaign

[18] *Senate Doc. No. 912, 61st Cong., 2d sess.*, Part I, 126.

for a tax on income spent on luxuries would aid much to bring about such a result.

When these facts are kept in mind, the argument evidently is strongly on the side of a policy that will shape fiscal legislation in such a way as to restrain rather than to encourage outlay. This is in no sense a demand for sumptuary restriction; it is merely a recommendation that such legislation as we have shall be directed into channels that will hinder rather than forward the drift toward uneconomic outlay and the establishment of unwise standards of consumption. Something has already been done in this direction by our system of taxes upon commodities, as exemplified in our internal revenue duties and in our tariff system. The latter system has not had a perceptible effect in restraining consumption, however, since it has been allowed to fall, both for protective and revenue purposes, most heavily upon the commoner commodities or necessaries of life. The internal-revenue system, both in this country and abroad, has undoubtedly had an important deterring effect in restraining the large consumption of the articles—chiefly tobacco and spirits—upon which it is imposed. This influence has been retarded in very large measure by the effort to get a maximum return, and the consequent retention of rates at a level insufficiently high to afford the check upon consumption which would otherwise have been furnished. This in itself suggests the larger use that might be made of the income tax as suggested, if it were solely a revenue measure. It also points the way to the successful use of the tax as a restraining influence, and strongly supports the view that its social significance might be made as great as its economic import.

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